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PRINCIPLES THAT MUST UNDERLIE MONETARY REFORM IN THE UNITED STATES[1]

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PANICS are acute infections of the body economic by the germ distrust. Varying causes may bring about a crisis, which always precedes a panic, but the degeneration of a crisis into a panic is invariably an epidemic of distrust.

Every modern financial system is built on confidence, on credit. Our whole financial structure has become a system of clearings of credit, a system of substituting the token of confidence for the payment in actual cash.

Against the immense amount of demand obligations payable by rights in cash at the option of the payee there is only a comparatively small amount of actual gold. The very moment that a general hesitation sets in to accept this clearing by credit, the very moment that a simultaneous request begins, calling for actual cash in payment of all demand cash obligations, a general collapse becomes inevitable. A modern system must be so constructed that a demand for cash caused by distrust shall be absolutely impossible, or the system is not safe, and the mere knowledge of its being unsafe will precipitate a panic whenever an acute crisis arises.

If a small fire starts in an old-fashioned wooden theater a catastrophe is unavoidable. The mere fact that everybody knows that he is in a fire trap and that the combustion will spread rapidly, brings about a panic with all its horrors of unnecessary loss of life and property. In a modern fireproof building the fire will be quickly extinguished: there will be less food for the flames, there will be a possibility of fighting them, and the feeling of safety will allow everyone to save himself

[1] A paper presented at the meeting of the Academy of Political Science, November 12, 1910.

without trampling his neighbor to death or blocking those who also want to escape. It is a critical situation, a crisis, which, thanks to modern construction and wise precaution, does not degenerate into a panic.

Why has our building proved a fire trap and why is Europe's structure safe? Why does Europe's system guarantee the avoidance of panics and why does ours inevitably insure their recurrence from time to time? It is from this point of view that all the material published by the National Monetary Commission ought to be studied and it is from this point of view that the final question of monetary reform must be approached.

Let us then lay down as the first principle which must guide all our further investigations, that no system which is by universal acknowledgment theoretically defective will ever stand the strain of an acute crisis without that crisis degenerating into a panic. It is of no avail to patch up a theoretically wrong system and to strengthen it by some practical measures which give a false assurance of safety. When the storm comes, fear and doubt will begin to creep in through the loophole which logic, then wide awake, will drill, and once well-founded distrust begins, the system loses its basis, which is confidence, and must collapse. Not every measure that is right in theory is good in practise; but what is wrong in theory can never be right in practise.

Let us lay down then the second fundamental principle, that a financial system which scatters and decentralizes reserves, making them unavailable and insufficient in case of need, is fundamentally wrong and defective.

In a modern system, constructed on credit, cash must be centralized as far as possible into one big reservoir, from which everyone legitimately entitled to it may withdraw it at will and into which it must automatically return whenever it is not actually used.

In order to achieve this there must be two guaranties: one, that the central reservoir is safe and strong enough to supply all the cash that may be required from it, so that nobody will hesitate to let it become practically the sole trustee of all cash; and the second, that every bank depositing its cash or allowing

it to stream into the central reservoir will be sure to have the means at its command with which to acquire the cash that it may legitimately have to demand.

In order that cash should always return into the central reservoir, cash must become less valuable than the interest-bearing right to command cash, which is embodied in a legitimate bill of exchange. To keep large supplies of explosives under our roof is a source of danger; the safer a community the less is the necessity for us to be provided with ammunition. It is the same with large cash holdings.

Individuals, corporations and banks alike in a modern household must try to reduce the holdings of cash to a minimum, because cash holding entails the risk of loss and robbery and because a hundred dollars carried in the pocket for a year, or needlessly hoarded, means a loss of four dollars. Instead of accumulating cash, the desire must prevail to dispose of it as quickly as possible and to turn it into cash credits or interest-bearing quick assets.

This leads to a clear division of the functions of the central reservoir and of the general banks. It is the function and duty of the general banks to act as the custodians of the people's money and deposits and to employ the same in conformity with the principle that a bank must not give any other credit than it receives, which means that against all demand deposits it must be able to provide at all times payment by cash credit. It is the function and duty of the central organ: first, to watch that the right proportion be maintained between all demand cash obligations of the country and the actual cash at its disposal; second, to guarantee that every legitimate cash credit can be transformed at will into actual cash; and third, to establish so firm a confidence in its ability to perform these duties that cash will never be withdrawn to be hoarded, but will always return promptly into the central reservoir, leaving in the hands of the banks and the public only the amounts absorbed by actual circulation or taken for gold exports by creditor nations.

From these different functions of the central banks and the general banks, there follow as a logical consequence the different elements necessarily inherent in their reserves. The central

bank, having cash obligations, must have the strongest possible reserve of cash and quick assets payable within a short time. The general banks, having obligations payable only in cash credit, need have reserves only in cash credit and in quick assets, convertible at all times into cash credit.

The channel that connects these two systems and enables them both to perform their functions in safety is the central bank's discount rate. The discount rate enables the general banks to build up a cash credit with the central bank, by rediscounting with it legitimate paper, and to draw actual cash against this cash credit, if necessary. It thus renders the maintenance of a large holding of actual cash unnecessary for the banks. An increase in the discount rate enables the central bank, on the other hand, to protect itself by collecting a larger proportion of its maturing bills discounted, decreasing at the same time the amount of new purchases of paper, and incidentally attracting foreign money or warding off gold exports. While cash payments continue without hesitation, the increased rate brings about a general contraction which will result in a safe ratio between the actual cash holdings of the nation and the grand total of its cash obligations.

The less actual cash is required in the process of paying debts and settling balances, the more developed is the system. This applies not only to the transactions within each city, but much more so to the settlements and payments between cities. Whenever a central bank opens a branch in a city, it means that from that day a bank of that community can deposit with that branch a given sum of money, and request that the amount be transferred to the credit of any other bank having an account with the head office, or any other branch of the central bank. This means that a great clearing system will come into existence all over the country, and that cash remittances for account of the general banks will cease to exist between places where there are central-bank branches.

We have repeatedly dealt at length with the folly of a system which makes the commercial paper purchased by a bank immovable assets, locking up the capital of the purchaser, and which forces the banks to consider as their only quick assets

cash in their vaults which they must not use, and call loans on the stock exchange which during a panic they cannot turn into cash.

We may then stop here for a moment and establish four general principles, as I would like to term them, which follow from our discussion up to this point:

I. Cash reserves must be centralized into one strong organization where they will be available when needed, and where they will command such confidence that they will not be withdrawn except for actual circulation or gold exports.

II. In order to secure the free return of cash into the central reservoir, there must be some means of exchange between the central reservoir and the banks, so that banks may rely on their ability to build up with the central reservoir a credit balance against which they may draw cash if necessary. This medium of exchange must be commercial paper (under safeguards to be discussed later on).

III. Fluidity of credit must be our final aim. A sound financial system must mobilize its commercial paper and make it a quick asset instead of a lock-up. Mobilized commercial paper, instead of bonds and loans on stock-exchange collateral, must finally become the most important basis of our financial structure. The larger reservoir must regulate the smaller one; not *vice versa*, as with us. Discounts in the main liquidate themselves within a comparatively short period, and by the natural process of consumption. Bonds, which are investments of long maturity, are not self-liquidating, but they and stock-exchange loans, which represent undigested securities, must be finally absorbed by the process of investment of the savings of the nation. This is at best a slow process, in which only comparatively few persons participate subsequently to the initial process of general consumption by all. Therefore no nation enjoying a modern financial system bases it primarily on bonds and stock-exchange loans.

IV. Clearings must not stop within the limits of a single city. Remittances of cash at cross purposes between cities are even more wasteful than within a city, for the loss of interest is so much heavier and the danger of cash withdrawals from one

city to another is so much greater in critical times. The central reservoir must act as an inter-city clearing house, as it does in Europe.

Here we have the four main general principles, to which, a little later, we shall have to add two more, concerning note issue. These four principles are so self-evident and so absolutely essential that once we recognize them clearly the work to be done by us in reforming our monetary system ceases to be bewildering and complicated. Our compass is set and the only question that remains is whether we can avoid the cliffs that endanger our course. To effect a centralization of reserves and a safe system of inter-city clearings ought not to frighten us as a problem offering insurmountable difficulties.

To the general principles governing every financial system we now add some principles which ought to be observed with reference to our peculiar conditions. These principles I should like to term the local principles. They are as follows:

1. The central reservoir must not be operated for profit. If it takes the form of a bank, as probably it must, the stock dividends must be limited to what would correspond to a fair investment basis. This moderate return might be guaranteed by the government, which in turn would receive the surplus earnings.

2. The central reservoir would have to be restricted in its operations. It should deal only with banks, bankers, and trust companies. Its main function should be to buy foreign exchange, which it should accumulate in times of ease as a gold reserve, and it should purchase commercial paper from banks and trust companies only.

The difficulty here is that we have as yet no standard discount paper such as exists in England, France and Germany, and that therefore, in order to avoid abuse, some system must be invented which will act as an effective control and which will supply an additional and safe guarantee. How this can be accomplished I have outlined in detail in an article entitled "A United Reserve Bank of the United States," which was published by the Academy for the Merchants Association of New York some six months ago and which forms a part of the

present volume. It would lead too far to go into details concerning the suggestions made in that essay. They are subject to modifications and were published only for the purpose of showing that it is possible without doubt to devise some scheme which, while strict enough to prevent any abuse, can still be made broad enough to allow of practical and effective operation.

3. The management of the central reservoir must be absolutely free from the dangers of control by politics and by private interests, singly or combined. This can be achieved without doubt by a combination of measures like the following: the stockholders would appoint only a minority of the directors; a small number of additional directors would be furnished *ex officio* by some political officers, but the majority could be appointed by groups of banks all over the country under a system, for instance, like that proposed in the above-named plan. These directors should elect and appoint the managing governor of the central organ, who would be chosen and engaged like any other bank president, without any political consideration, but with due regard to ability and character alone.

But safety would have to lie not only in this mode of election, but also and mainly in the limitation of the profits and in the restriction of the operations of the central organ. A stock offering a maximum return of 4 % combined with the restriction that the central reservoir may not do anything else but buy certain clearly circumscribed paper under the strictest guarantees and injunctions, cannot possibly involve any danger from monopolistic or political domination.

4. The treasury should cease to deal directly with the banks. The central reservoir should be the recipient of the government's surplus funds and should attend to the government's disbursements. The influence in business of the treasury, a purely political body, must cease.

5. Cash balances with the central reservoir or its branches must be considered and counted by the banks as cash in their own vaults. The central organ must have power to request the banks to keep with it cash balances proportionate to the amount of their deposits.[1] Thus every bank will be made to contribute

[1] "Banks" always means national banks, state banks and trust companies.

to the work of the central reservoir, of maintaining a safe proportion between all cash obligations of the nation and its actual cash, a work which, with the lack of a fully developed discount system, would otherwise remain much less effective. It is fortunate that existing circumstances allow such a measure—which is more far-reaching than similar arrangements in Europe—without adding any new burden to the banks which are in the habit of keeping these large cash reserves. The immense advantage to be gained, without any sacrifice made by the banks, will be, that the vast sums of cash accumulated in the central reservoir will be freely forthcoming when needed, and will insure safety, instead of being helplessly and hopelessly stored up by the individual banks.

6. The central organ must be in a position to contract for temporary loans of gold with other governments or foreign central banks, and to receive or give collateral therefor.

This clause is self-explanatory. The power that this measure would confer would go a long way toward allaying fear, and thereby strengthen and benefit the system, even if the privilege were never made use of.

We have thus far left entirely out of consideration the question of note issue. We have done this because the problem loses so much of its complexity and presents itself so much more clearly if the question of notes, which is only a side issue, is temporarily disregarded; and secondly, it is just because we wanted to show how comparatively unimportant this question of note issue really is, that we have endeavored to present the structure in its fundamental lines complete in itself without embodying note issue from the beginning.

To try to remedy the shortcomings of our present system by reorganizing only the note issue, as many reformers have done, is to attempt to repair a broken-down carriage by hitching to it a fresh horse. Effective centralization of reserves and the creation of fluidity of credit are the main questions. Elastic note issue is a side question, though a very important one.[1]

[1] A full argument concerning this point is embodied in the author's article, "A United Reserve Bank of the United States," to which reference is made. The writer apologizes for some unavoidable restatements contained in the present essay.

V. We may now enumerate our fifth general principle, which is this: Inasmuch as note issue, partly secured by gold, is only an auxiliary activity of the central reservoir, the note-issuing power ought to be centralized as far as possible in the central reservoir. For not only does this uncovered note issue give additional safety to the central reservoir, but there is inherent in it a certain regulative power which is lost and endangered by an excessive decentralized and scattered additional note issue. The point is plain: If notes issued by other banks must be paid by them in cash, these other banks would again become accumulators of cash and thus interfere with the free return flow of cash into the central reservoir. This would be a fundamental danger. If, on the other hand, they could rely on the central reservoir to redeem their notes in cash, they could work at cross purposes with the central reservoir, antagonize its restrictive policy, weaken its position, and still throw on it the entire burden of final cash regulation.

Bank notes are deposits on demand in bearer form, passing as cash. If we desire to authorize the issue of bank notes partly secured by bills purchased and only partly secured by gold—as there cannot be any doubt we should—the duty to make sure that this proportion remain within safe limits and that the notes always be met by actual cash must be left to the same organ that guarantees the prompt transformation of every cash token into actual cash.

VI. Furthermore, the function of making money and of issuing money are at times distinctly opposed, and the performance of these functions should lie in entirely separate bodies.

In developing these principles I am not unmindful of the fact that in Europe also there are countries where note issue is not entirely centralized. Changes in a monetary system have to be perfected with extreme care and patience, and everywhere it has been necessary to live through periods of compromise before finally reaching the coveted goal. In Germany, where there were thirty-two banks of issue, there are now only five, including the Reichsbank, which now, as a matter of fact, has become the all-important regulator. The other banks have been brought into a state of coördination where they have to coöperate in following the Reichsbank's lead.

We, too, shall have to be prepared for a period of compromise concerning note issue. We have before us a complex problem, inasmuch as there are at present in circulation too many inelastic and unsecured, or poorly-secured notes, like the national-bank notes, the greenbacks, and the silver notes. To convert at once any and all of them into the notes of the central organ would be too large an undertaking at this time. However, we may safely leave in circulation about half the amount now outstanding, to serve as the pocket money of the people, and begin by substituting the new elastic notes of the central organ for the other half. For elasticity means not only expansion, but also contraction. We must instil into our present system a sufficient amount of elastic notes—elastic because, being issued against bills purchased, they are withdrawn from circulation when the money paid for this paper at maturity is not reinvested in the purchase of other bills. If the bank cannot contract its notes in time of ease, it cannot expand as far as it should in times of stress. The principle ought therefore to be established that an ample portion of our present unsecured notes ought to be withdrawn and replaced by the notes of the central organ.

This, again, is not an impossible task. We have outlined in our previous plan how it could be accomplished by withdrawing the national-bank notes and leaving the greenbacks and silver notes in circulation.

We could well imagine another plan,[1] which is advocated also by Prof. Sprague of Harvard, in connection with suggestions now made by him for a modified form of a central bank. This plan would probably be more popular, though in my opinion not quite so sound. It is a scheme which would for the time being leave the national-bank notes and silver certificates undisturbed and provide for the redemption of the greenbacks. The government would deposit with the central organ the $150,000,000 gold held against the 356 millions of greenbacks now outstanding. The central organ would assume these greenbacks and we would suggest that it receive in turn the privi-

[1] *Quarterly Journal of Economics*, Feb., Aug. and Nov., 1910.

lege of calling on the government in times of stress to pay for the remaining 200 millions, which the government would have the privilege of doing either by issuing to the central organ some short treasury bonds or by paying in cash. This would enable the bank in case of extreme demands to place the treasury bonds at home or abroad and break the pressure on its gold holdings. The surplus earnings of the central organ should be applied under this plan as a gradual redemption fund of the outstanding government bonds held by the national banks, and if, later on, it should be found necessary, the redemption of the government bonds in the hands of the banks might be accelerated by other means.

7. No matter what may happen, not one additional government bond must be issued, carrying with it the privilege of further note issue by the national banks. While the national banks, which acquired these bonds in the past, are entitled to full and fair protection as to their present holdings, this reckless inflation of our currency system, which even to-day is a severe obstacle to monetary reform, must not be allowed to increase and thereby further weaken our miserable system.

8. Automatic taxes governing scattered note issue cannot bring about a safe and practical regulation. Conditions vary; a drain from within has to be met in a different way from a drain coming from without. Demands originating in healthy periodical economic developments must be treated in a different way from demands caused by over-expansion and over-speculation. In a large country covering the most varying geographical, social, and economic conditions, one ironclad tax, applied without possible discrimination to all alike at the same time, will do harm in one corner while it does good in another.

The system must provide for the use of brains and for a wise power of discrimination, though the regulative power must be so strictly circumscribed that there can be no other motive but the general good in deciding upon the questions as they arise. The elimination of any possibility of gain, the restriction of the functions of the central organ and the composition of its board will guarantee this.

One word in closing. With a structure as defective as ours,

we cannot expect to develop at once an absolutely perfect new system. Monetary reform must try to perfect changes without violently upsetting existing conditions. The principles laid down here, and the details contained in my previous plan fully allow for this. The changes proposed leave the business of the banks and even their methods almost untouched. In order to do this, the so-called local principles must adapt themselves to conditions. However, there must not be the slightest compromise in two respects: The changes must err rather on the side of safety than on the side of immediate perfection and the fullest efficiency; and furthermore, they must contain nothing that is in contravention of those general principles which can be neglected only by endangering the whole structure.

Centralization of reserves, effective concentration of note issue, and fluidity of credit, strongly safeguarded, though thereby somewhat clumsy in the beginning, are the rules that must and can be observed. They are the only means of safely killing the germ distrust, or, to change the metaphor, of averting the ignominious struggle for life in a fire-trap. Unless we follow these lines we shall again see the sorry day when banks will trample each other to death in the mad attempt at saving themselves, till general suspension will put an end to this disgraceful scramble, marking in turn only the beginning of untold misery for the nation.

Slowly but surely it is becoming evident to the nation—and if the work of the Monetary Commission had accomplished nothing more, it would have done a great deal—that central banks are not oligarchic but democratic institutions, that central banks by creating safe conditions render the small banks independent of the dominion of the large institutions, and that in Europe the central banks are the backbone of the independent banks in their fight against the ever-growing branch-banking system.

A system of centralized reserves and decentralized banking power is clearly the one that this country requires, and it is my conviction that it will gladly accept it when once that system is clearly presented to it in definite form.

I have here avoided the name central bank, and have used

the name central reservoir, just as in my previous articles I have termed the institution a central reserve bank or a united reserve bank. This has not been done from cowardice, for the purpose of avoiding a name against which popular prejudice ran high. It has been done for the reason that, first of all, the name expresses what is to me the most important feature of the problem, namely, the centralization of reserves. The second reason is that we should not have, and what we suggest is not, a central bank. Wherever central banks exist, their powers are infinitely wider; they are real banks privileged to do almost a complete general banking business. The central organ, on the other hand, as here suggested, though securing to us the principal advantages of the central-bank system, is nothing but a central reservoir, precluded from doing a general banking business and invested only with such functions as it absolutely needs for its own protection and for the protection of the nation.

It has been a great privilege to be allowed to read this paper under the auspices of this academy and the commercial bodies uniting with it in this national conference and under the eyes of the members of the Monetary Commission. We wish the latter Godspeed. May success be with them and may they take up this momentous work without any further delay.

These years have been well employed in locating the evil and in clearly diagnosing the case. But now is the time to perform the operation, before the patient gets another relapse. Let us hope that this question, which is non-partisan—for as far as we remember we did not find that Republican faces looked any different from Democratic ones during the panic—will be solved on non-partisan lines and that new nationalism will bury the hatchet before the vastly more important question of new national-bankism.